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SELLER'S RIGHT OF RECLAMATION UNDER THE BANKRUPTCY CODE

Thomas J. Romans*

A seller's right to reclaim goods sold on credit to an insolvent buyer who subsequently enters bankruptcy has enjoyed long-standing recognition.¹ This common law remedy is continued in section 2-702 of the Uniform Commercial Code.² Louisiana grants a lien to sellers in the form of a vendor's privilege.³ The seller reclaiming under U.C.C. section 2-702, however, sometimes was defeated in bankruptcy proceedings for a variety of reasons, such as the reclamation right being determined to be a statutory or state-created lien or preference in conflict with the federal bankruptcy statute.⁴ The federal courts became divided on the recognition of this right in bankruptcy proceedings for divergent reasons.⁵ The Bankruptcy Reform Act, which became effective October 1, 1979,⁶ sought to grant recognition

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1. *Donaldson v. Farwell*, 93 U.S. 631 (1876). See Bjornstad, *Reclamation of Goods by Unsecured Sellers in Bankruptcy Proceedings*, 24 DRAKE L. REV. 357, 359-60 (1975); Ashe, *Reclamation Under UCC—An Exercise in Futility*, *Defrauded Seller v. Trustee in Bankruptcy*, 43 REF. J. 78, 79-80 (1969).

2. U.C.C. § 2-702 (1972 version). See note 18, *infra*, and accompanying text.

3. LA. CIV. CODE art. 3227 provides in part:

He who has sold to another any moveable property, which is not paid for, has a preference on the price of his property, over the other creditors of the purchaser, whether the sale was made on a credit or without, if the property still remains in the possession of the purchaser.

This statutory preference accorded sellers of movables does not extend to sellers who make sales outside Louisiana. *In re Hoover*, 447 F.2d 195 (5th Cir. 1971). As of the date this article was written, Louisiana had not adopted Article 2 (Sales) of the U.C.C. but had adopted Articles 1, 3, 4, 5, 7, and 8. See generally Mashaw, *A Sketch of the Consequences for Louisiana Law of the Adoption of "Article 2: Sales" of the Uniform Commercial Code*, 42 TUL. L. REV. 740 (1968).

4. See generally Seibert, *The Seller's Right to Reclaim: Another Conflict Between the Uniform Commercial Code and the Bankruptcy Act?*, 52 NOTRE DAME LAW. 219, 220-21 (1976); Weintraub & Edelman, *Seller's Right to Reclaim Property Under Section 2-702 (2) of the Code Under the Bankruptcy Act: Fact or Fancy*, 32 BUS. LAW. 1165, 1170-72 (1977).

5. See generally 3A Bender's U.C.C. Service, R. DUESENBERG & L. KING, *Sales & Bulk Transfers Under the Uniform Commercial Code* § 13.034[a] (1980 ed.).

6. The Act to Establish a Uniform Law on the Subject of Bankruptcies, Public Law 95-598, 92 Stat. 2549, was signed by President Carter on November 6, 1978, and by its terms became effective October 1, 1979. Title I of Public Law 95-598 codifies and enacts as Title 11 of the United States Code the law relating to "Bankruptcy." The new Title 11 replaces the Bankruptcy Act of 1898, which is repealed by section 401 of Public Law 95-598, and is referred to as the Bankruptcy Code, or Code. There is an

to this important creditor right and to remove the uncertainty faced by sellers seeking reclamation.⁷ This article will discuss how effectively the new bankruptcy law, referred to as the Bankruptcy Code, or Code, has eliminated this uncertainty connected with reclamation prior to the Code.⁸

TRADITIONAL RECLAMATION RIGHTS

As a general rule the seller has the right to reclaim goods sold to an insolvent buyer, regardless of whether the buyer becomes involved in bankruptcy proceedings.⁹ In a typical case, the seller ships merchandise or supplies to a buyer who, unknown to the seller, is in financial straits and trying to keep his business operations alive by requesting extended credit terms from key suppliers. At early common law the seller, once aware of the buyer's inability to pay and having parted with both possession and title to the goods, was unable to stop the goods in transit or to reclaim them from the buyer.¹⁰ Exceptions to this rule quickly emerged with respect to goods of a unique character or exclusive privileges, such as patents and copyrights.¹¹ The courts eventually reasoned that when the buyer had misrepresented his ability to pay, the buyer's title was subject to divestment by reason of the buyer's fraud, and the seller should be permitted to rescind the sale and reclaim the goods.¹²

Reclamation at common law was an exclusive remedy. The reclaiming seller was required to return any payment received and was unable to recover damages.¹³ Reclamation also was recognized when bankruptcy proceedings commenced after the seller had ship-

approximate five-year transition period before the new United States bankruptcy court system becomes effective on April 1, 1984.

7. See 4 W. COLLIER, BANKRUPTCY ¶ 546.04[1] (15th ed. 1980).

8. This article assumes that the reader has little or no familiarity with the subject of bankruptcy. The fundamental principles involved are summarized to facilitate an understanding of the context in which reclamation arises and of the competing interests involved.

9. It is beyond the scope of this article to discuss the historical development of the right of reclamation. Other writers already have done so. See 12 S. WILLISTON, CONTRACTS § 1458 (3d ed. 1970); Hawkland, *Relative Rights of Lien Creditors and Defrauded Sellers—Amending the Uniform Commercial Code to Conform to the Kravitz Case*, 67 COM. L.J. 86 (1962). For cases permitting reclamation in bankruptcy, see Comment, *Bankruptcy-Reclamation and the Uniform Commercial Code*, 33 MO. L. REV. 262, 266-69 (1968).

10. See S. WILLISTON, *supra* note 9, at § 1458.

11. *Id.*

12. See Ashe, *supra* note 1, at 79-81.

13. See, e.g., Walker v. L. Maxcy, Inc., 103 F.2d 24 (5th Cir.), *cert. denied*, 308 U.S. 564 (1939).

ped the goods.¹⁴ If the goods had been sold or used by the debtor or the trustee and reclamation was granted, the seller was entitled to the proceeds of the sale.¹⁵ The need for reclamation was highlighted when large retail or retail chain establishments, suddenly and without warning, were immersed in bankruptcy proceedings.¹⁶

Prior to the advent of the Uniform Commercial Code, the proof necessary to establish the right to reclaim was often onerous. Sellers at times were required to: (1) identify their goods in the hands of the debtor or trustee in bankruptcy, (2) establish fraud with clear and convincing proof, (3) prove that the buyer was insolvent when the sale was consummated and did not intend to pay, (4) show that these facts were concealed knowingly by the buyer from the seller, and (5) prove that these misrepresentations of the buyer were material.¹⁷ The seller's evidentiary task was simplified with the appearance of the U.C.C.

SECTION 2-702 OF THE UNIFORM COMMERCIAL CODE

The U.C.C. in one major respect simplifies the task of the reclaiming seller by creating an irrefutable presumption of fraud.¹⁸ U.C.C. section 2-702¹⁹ extends the protection afforded the seller of

14. See note 1, *supra*. See also Shanker, *Bankruptcy and Article 2 of the Uniform Commercial Code*, 40 REF. J. 37 (1966). Reclamation proceedings in bankruptcy prior to the Bankruptcy Code did not have a definite statutory basis. These proceedings developed from attacks on the trustee's lack of title to property otherwise vested under section 70(a) of the Bankruptcy Act. See Comment, *supra* note 9.

15. *Thomas v. Taggart*, 209 U.S. 385 (1908).

16. See Weintraub & Edelman, *supra* note 4, at 1175.

17. See *O'Rieley v. Endicott-Johnson Corp.*, 297 F.2d 1 (8th Cir. 1961); Kennedy, *The Trustee in Bankruptcy Under the Uniform Commercial Code: Some Problems Suggested by Articles 2 and 9*, 14 RUTGERS L. REV. 518, 549-56 (1960).

18. U.C.C. § 2-702 (1972 version); Comment, *supra* note 9. See King, *Reclamation Petition Granted: In Defense of the Defrauded Seller*, 44 REF. J. 81, 82 (1970). But see Countryman, *Buyers and Sellers of Goods in Bankruptcy*, 1 N. MEX. L. REV. 435, 455 (1971).

19. U.C.C. § 2-702 (1962 version):

(2) Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply. Except as provided in this subsection the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.

(3) The seller's right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course or other good faith purchaser or *lien creditor* under this Article (Section 2-403). Successful reclamation of goods excludes all other remedies with respect to them.

(Emphasis added). The foregoing constitutes the 1962 version. The 1972 version

goods on credit by the common law. When the seller discovers that the buyer has received goods on credit while insolvent, the seller may reclaim upon demand, verbal or written, within ten days after the buyer's receipt of the goods. The seller's right to reclaim under section 2-702 is intended to replace the common law right of reclamation, but this right can be cut off by those who purchase the goods from the buyer in good faith or in the ordinary course of business.

The U.C.C., however, limits the seller's right in other respects. Unless the seller gives notice within ten days of the buyer's receipt of the goods, the seller may reclaim only if there has been a written misrepresentation of solvency within the three months prior to the buyer's receipt of the goods. The right of reclamation, if exercised, is the seller's exclusive remedy concerning the goods at issue. Accordingly, the seller should not be permitted to claim a deficiency and share in the distribution of assets to the general creditors of the bankrupt.²⁰ Subsection (1) of section 2-702 recognizes the seller's right to stop delivery or refuse delivery except for cash under section 2-705 of the U.C.C. when the seller discovers the buyer to be insolvent.²¹

RECLAMATION UNDER THE U.C.C. IN BANKRUPTCY PROCEEDINGS

Although sellers usually had fared well in reclamation actions under pre-U.C.C. law, sellers seeking reclamation under U.C.C. section 2-702 encountered numerous challenges by trustees in bankruptcy or by debtors in possession.²²

deleted the phrase "or lien creditor" as a measure to avoid one area of conflict with the Bankruptcy Act.

20. See Sebert, *supra* note 4, at 220. But see R. DUESENBERG & L. KING, *supra* note 5, at § 13.03[2] 13-13. A proof of claim is a request to share in the bankrupt's general assets (an unsecured claim) or in a specific asset of the bankrupt (a secured claim), while reclamation is a demand that the seller's property be returned to the seller. Filing of a claim, therefore, may be treated as a final election of remedies and a waiver of reclamation. See *In re Myley Elec. Supply Co., Inc.*, 291 F. 775 (E.D.N.Y. 1923).

21. Subsection 1 of section 2-702 of the Uniform Commercial Code provides: "Where the seller discovers the buyer to be insolvent he may refuse delivery except for cash including payment for all goods theretofore delivered under the contract, and stop delivery under this Article (Section 2-705)." See generally Levy, *Effect of the Uniform Commercial Code Upon Bankruptcy Law and Procedure*, 60 COM. L.J. 9 (1955); Note, *A Seller's Remedies on Discovery of Buyer's Insolvency Under the Uniform Commercial Code*, 58 DICK. L. REV. 158 (1954).

22. See Note, *UCC 2-702(2) and the Bankruptcy Act: To Lien or not to Lien*, 50 ST. JOHN'S L. REV. 725, 726 (1976) (for a compilation of cases illustrating the conflict between the Bankruptcy Act and section 2-702 of the UCC). Although it has been said that reclamation is not viewed with favor in bankruptcy, the remedy traditionally was allowed because it was considered unjust to grant the bankrupt estate title to property belonging to another. *Id.* at 744. To the extent that fraud is no longer a requirement, the consideration that reclamation may disrupt the careful balance between

A key purpose of the bankruptcy laws is to ensure a uniform and equitable distribution of the bankrupt's assets among the creditors. The trustee stands in the shoes of the bankrupt in that he takes title to the bankrupt's property subject to existing rights and security interests of third parties existing as of the commencement of bankruptcy.²³ The trustee distributes the proceeds of these assets to creditors, who are secured or unsecured. The debtor in possession has this role if no trustee is appointed. The secured creditor has a security interest in, or a lien against, specific property and is entitled to payment from the proceeds of the sale of that property. Complete equality of distribution is not always feasible. Accordingly, bankruptcy law establishes an order of priority for the payment of certain types of unsecured claims prior to pro rata distribution of the unencumbered assets among the remaining unsecured creditors. Generally speaking, the order of priority is: (1) administration expenses, (2) certain wage claims and contributions to employee benefit plans, (3) consumer creditor claims, and (4) certain tax claims.²⁴

Early concern existed in Congress that state-created priorities would destroy the federal priorities specified by the bankruptcy provisions. The Bankruptcy Act of 1898 recognized the validity of state priorities. The 1938 Congress amended the Act to recognize only state-created priorities in favor of landlords, thus nullifying creditors' attempts to gain the advantage of other state-created priorities. However, resourceful creditors turned to state-created statutory liens to preserve this advantage.²⁵

Actions taken by the debtor or aggressive creditors in the immediate pre-bankruptcy period could undermine fundamental policies of the Bankruptcy Code by favoring one or more creditors over other creditors in the distribution of the estate, notwithstanding that the rights of parties generally are fixed as of the filing of the petition, which commences the bankruptcy. Likewise, the imposition of state-created liens favoring certain creditors could interfere with these policies. The Code (like prior law under the Bankruptcy

the seller and other creditors of the estate takes on greater importance. Accordingly, equity may be sacrificed to achieve uniformity, administrative simplicity, and ease of application. *Id.* at 744.

23. W. COLLIER, *BANKRUPTCY MANUAL* ¶541.01-.08 (3d ed. 1980).

24. 11 U.S.C.A. § 507 (1978). See TROST, TREISTER, FORMAN, KLEE & LEVIN, *RESOURCE MATERIALS—THE NEW FEDERAL BANKRUPTCY CODE*, ALI-ABA COMMITTEE ON CONTINUING PROFESSIONAL EDUCATION (1979); H. MILLER & M. COOK, *A PRACTICAL GUIDE TO THE BANKRUPTCY REFORM ACT* (1979), for a discussion of the workings of the new Bankruptcy Code.

25. *But see* TROST, TREISTER, FORMAN, KLEE & LEVIN, *supra* note 24, at 141-42.

Act) grants to the trustee and debtor in possession the power to avoid certain transactions or transfers, such as judicial liens, preferences, and fraudulent transfers, occurring within defined periods prior to the commencement of the bankruptcy proceeding. Moreover, the trustee has the power to avoid executory contracts that may be onerous to the estate of the bankrupt. In order that the trustee be capable of avoiding such transfers, he is given the status as successor to both hypothetical creditors (the "strong arm") and real creditors.²⁶

Like section 70(c) of the former Bankruptcy Act, section 544(a)(1) and (2) of the Code grants to the trustee the rights of a hypothetical lien creditor with a judicial lien on all of the assets of the debtor as of the date of the commencement of the case. This provision is known as the "strong arm clause" and enables the trustee to set aside unperfected security interests and other transfers that would be invalid against a creditor who levied under state law on the date of the bankruptcy.²⁷ A debtor in possession has these same powers pursuant to section 1107 of the Code. The Code clarifies the strong arm clause by providing that the trustee's rights are not dependent on the existence of an actual creditor who could have obtained these rights.

Section 70(e) of the old Bankruptcy Act enabled the trustee to avoid transfers which an actual creditor with a provable claim could have avoided under state law. Such transfers were set aside for the benefit of all creditors even though they might have been invalid only as to one actual creditor with a provable claim. This concept was carried forward into section 544(b) of the Code, which dispenses with the concept of a provable claim and overrules the cases entitling the trustee to rely on the rights of an actual secured or lien creditor. Now, a trustee may avoid a transfer under section 544(b) by resorting to an allowable, unsecured claim.

Section 67 of the Bankruptcy Act provided in general terms that a statutory lien was invalid if it first arose on the debtor's insolvency, or if it was not good as against a bona fide purchaser. The Code

26. *Id.* at 135-49. The Code made substantial changes to the trustee's avoiding powers; for a more detailed discussion of these see Levin, *An Introduction to the Trustee's Avoiding Powers*, 53 AM. BANK. L.J. 173 (1979). The "date of the bankruptcy" generally refers to the commencement of the bankruptcy proceedings brought on by the filing of a petition, either voluntarily by the debtor or involuntarily by one or more creditors. See W. COLLIER, *supra* note 23, at ¶¶301-303.

27. With respect to a transfer of real property, section 544(a)(3) of the Code confers on the trustee the status of a hypothetical bona fide purchaser from the debtor at the commencement of the case. See W. COLLIER, *supra* note 23, at ¶544.06; Levin, *supra* note 26, at 174.

is similar in effect.²⁸ Moreover, the Code continues the policies of avoiding fraudulent transfers (section 548) and preferential transfers made within ninety days of filing the petition (section 547(b)).

The trustee's powers of avoidance are not without limitation. Section 546 of the Code permits the post-petition perfection of a statutory lien to have retroactive effect. Accordingly, section 9-301(2) of the U.C.C. permits perfection of a purchase money security interest to relate back to defeat an intervening lien creditor, so long as the purchase money interest is perfected within ten days after the debtor obtains the collateral.²⁹ If perfection of a lien must be done by seizure, section 546(b) of the Code permits this to be accomplished by notice.

Prior to the Code, reclamation actions under section 2-702 of the U.C.C. were challenged successfully and found to be invalid as a priority lien under section 70(c), a statutory lien under section 67(c)(1)(A), or a state-created priority or voidable preference under sections 65(a) and 60 of the Bankruptcy Act.³⁰ The federal courts were widely divided as to the applicability of these provisions under the Bankruptcy Act.³¹ One response by at least eighteen state legislatures to preserve reclamation under section 2-702 was to delete the phrase "or lien creditor" from section 2-702(3) and thereby avoid the apparent conflict with section 70(c) of the Bankruptcy Act.³² Nevertheless, the other grounds for challenge remained, perhaps the most formidable of which was that section 2-702 constituted a statutory lien under section 67 of the Bankruptcy Act. For example, the United States Court of Appeals for the Fifth Circuit held in the case of *In re Trahan* that the Louisiana vendor's privilege is a statutory lien.³³ Numerous authors, however, urged that section 2-702 should be viewed as a codification of the common law cause

28. 11 U.S.C.A. § 545 (1978).

29. 11 U.S.C.A. § 362(b)(3) states clearly that actions taken to perfect a security interest after the filing of the bankruptcy petition will not be stayed by the automatic stay provision of section 362 of the Code. Section 362 essentially stays the pendency of all actions and proceedings against the debtor and his estate.

30. See Ashe, *supra* note 1, at 79-80. See also R. DUESENBERG & L. KING, *supra* note 5; Sebert, *supra* note 4, at 232-34.

31. See R. DUESENBERG & L. KING, *supra* note 5; Braucher, *Reclamation of Goods From a Fraudulent Buyer*, 65 MICH. L. REV. 1281 (1967).

32. State Correlation Tables, U.C.C. REP. (1980 Supp.) See *In re Daylin, Inc.*, 596 F.2d 853 (9th Cir. 1979); Shanker, *A Reply to the Proposed Amendment of UCC Section 2-702(3): Another View of Lien Creditor's Rights vs. Rights of a Seller to an Insolvent*, 14 WES. RES. L. REV. 93 (1962).

33. *In re Trahan*, 283 F. Supp. 620 (W.D. La.), *aff'd*, 402 F.2d 796 (5th Cir. 1968), *cert. denied*, 394 U.S. 930 (1969). The court found, interestingly, that because the privilege was effective whether or not the buyer was insolvent, section 67 did not apply.

of action and should be granted the same position in bankruptcy proceedings.³⁴

BANKRUPTCY CODE SECTION 546—THE LEGISLATIVE RESPONSE

Section 546(c) of the Code is "a legislative response to the judicial confusion concerning the validity of § 2-702 of the Uniform Commercial Code in a bankruptcy case."³⁵

Section 546(c) of the Code provides that:

The rights and powers of the trustee under sections 544(a), 545, 547, and 549 of this title are subject to any statute right or common-law right of a seller, in the ordinary course of such seller's business, of goods to the debtor to reclaim such goods if the debtor has received such goods while insolvent, but—

(1) such a seller may not reclaim any such goods unless such seller demands in writing reclamation of such goods before ten days after receipt of such goods by the debtor; and

(2) the court may deny reclamation to a seller with such a right of reclamation that has made such a demand only if court—

(A) grants the claim of such a seller priority as an administrative expense; or

(B) secures such claim by a lien.

The comments by the House and Senate committees also highlight the intent to clear up the confusion surrounding reclamation in bankruptcy situations:

The purpose of the provision [§ 546(c)] is to recognize, in part, the validity of Section 2-702 of the Uniform Commercial Code, which has generated much litigation, confusion, and divergent decisions in different circuits.³⁶

Section 546(c) protects "any statutory right or common-law right of a seller" to reclaim goods delivered to an insolvent debtor. This protection is accomplished by subordinating the trustee's rights under section 544(a) (trustee as lien creditor and as successor to certain creditors and purchasers), section 545 (avoidance of statutory

34. See, e.g., R. DUESENBERG & L. KING, *supra* note 5, at § 13.03[4][d][iv]; J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* § 7-15 (1972); Henson, *Reclamation Rights of Sellers Under Section 2-702*, 21 N.Y.L.F. 41 (1975); Note, *Bankruptcy and Article Two of the Uniform Commercial Code: The Right to Recover the Goods Upon Insolvency*, 79 HARV. L. REV. 598 (1966); Comment, *Statutory Liens Under Section 67c of the Bankruptcy Act: Some Problems of Definition*, 43 TUL. L. REV. 305 (1969).

35. W. COLLIER, *supra* note 7, at ¶546.04[1].

36. H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 371-72 (1977); S. REP. NO. 95-989, 95th Cong., 2d Sess. 86-87 (1978).

liens), section 547 (preferences), and section 549 (post-petition transactions).

The seller must take prompt action to protect his interests by making a *written* demand for reclamation within ten days *after or prior to* the time the debtor has received the goods.³⁷ Contrary to section 2-702 of the U.C.C., section 546(c) of the Code permits a demand for reclamation prior to the buyer's receipt of the goods, but does not extend the ten-day period if a written misrepresentation of solvency has been made. Also, no provision is made for oral notice permitted under the Uniform Commercial Code. Section 2-702 by its terms excludes resort to common law reclamation, yet section 546(c) gives express recognition to such common law reclamation rights.

The right of reclamation is limited. Section 546(c)(2) grants to the court the discretion to deny the demand, but, in doing so, it must protect the seller either by granting him an administrative expense priority claim or by securing the seller's claim with a lien. This discretionary right to deny reclamation furnishes the courts and trustees with the important ability to preserve goods that are critical to the continued operation of the debtor's business. Consistent with prior law under the U.C.C., the seller's rights in the goods may be cut off by a good faith purchaser from the debtor. Also, the reclaiming seller's rights are subject to any superior rights of other creditors under any applicable non-bankruptcy laws. The legislative history does not indicate which persons possess "superior rights." According to a leading authority, this category would include at least a buyer in the ordinary course of the debtor's business and a good faith purchaser.³⁸ The bankruptcy court will be able to determine these conflicting interests under its expanded jurisdiction, which permits the bankruptcy court to adjudicate the entire controversy.³⁹

The language of section 546(c) has given rise to debate concerning its interpretation.⁴⁰ The statute reads in part: "The rights and powers of the trustee under sections 544(a), 545, 547, and 549 of this title are subject to any statutory right or common-law right of a

37. No time limit generally was imposed under the prior Bankruptcy Act for filing a reclamation petition. See *Nauman Co. v. Bradshaw*, 193 F. 350 (8th Cir. 1912).

38. W. COLLIER, *supra* note 7, at ¶546.04[2]n.12.

39. 28 U.S.C.A. § 1471(b) (1978). The Code grants expanded jurisdiction so that virtually every civil matter related to a bankruptcy case will be within the jurisdiction of the bankruptcy court.

40. See Orr & Klee, *Secured Creditors Under the New Bankruptcy Code*, 11 U.C.C.L.J. 312, 342-45 (1979); Levin, *An Introduction to the Trustee's Avoiding Powers*, 53 AM. BANK. L.J. 173, 197-98 (1979).

seller . . . to reclaim . . . goods" One view is that only if the right of reclamation is subject to being avoided under one or more of the enumerated avoiding powers, *i.e.*, sections 544(a), 545, 547, or 549, may the court deny reclamation; but the court then must give the seller an administrative expense claim or a lien in lieu of reclamation.⁴¹ If the trustee is unable to avoid reclamation under any of the enumerated powers, it may be argued that the savings clause does not apply and the seller is not entitled to his goods, by virtue of the automatic stay provisions of section 362 of the Code. Another view is that reclamation applies regardless of whether or not the right of reclamation could be avoided by the trustee under any of the enumerated avoiding powers.⁴²

If this latter view prevails, and reclamation has been properly demanded and is otherwise valid, the automatic stay provision of section 362(a) of the Bankruptcy Code can be invoked by the trustee to prevent reclamation of the goods; but the seller is entitled to the protection of his interest, by way of either security or an administrative expense claim. If the former view prevails, reclamation will be the exclusive remedy, and the court cannot substitute a lien or an administrative claim for the goods. It is uncertain whether the seller, upon being granted a lien, is entitled to adequate protection under section 361 of the Code, and as a secured creditor, interest under section 506(b).⁴³

Regardless of which view is adhered to, section 546(c) does not offer blanket protection from the trustee's avoiding powers found elsewhere in the Code and omitted from section 546(c), such as the avoiding powers under section 544(b) (succession to actual unsecured creditors), section 548 (fraudulent conveyances), section 553 (setoff), section 510(c) (subordination), and section 551 (preservation of avoided transfers). If a trustee uses these avoiding powers successfully, and the claim is not otherwise secured or subject to setoff or disallowance, it may be allowed under section 502 as a general unsecured claim.

Two writers have pointed to at least three possible outcomes under section 546(c): (1) If the right of reclamation is not avoidable by the trustee under the Code, the right is valid but the seller's reclamation petition is stayed automatically by section 362; (2) if the right is avoidable only under the powers enumerated (*i.e.*, sections

41. See W. COLLIER, *supra* note 7, at ¶546.04[2].

42. *Id.* See 2 W. COLLIER, *supra* note 23, at ¶546.05.

43. See W. COLLIER, *supra* note 7, at ¶546.04[2]. As a general rule, if the trustee will have the use of a secured creditor's collateral, the creditor under section 361 of the Code is entitled to "adequate protection," a term not defined by the Code.

544(a), 545, 547, or 549), the seller's right must be granted subject to the court's avoidance and provided the seller receives a lien or administrative claim; or (3) if the right is avoidable under avoiding powers other than those enumerated (*e.g.*, fraudulent transfer), the right is defeated and the seller is left with an unsecured claim.⁴⁴ This line of reasoning seems to give recognition to section 2-702 reclamation only in jurisdictions wherein reclamation rights were unenforceable under the former Bankruptcy Act by reason of one or more of the Act's counterpart provisions enumerated in section 546(c). Therefore, whenever reclamation was allowed under the former Act, reclamation would not be acknowledged presently under section 546(c) of the Code; the seller's reclamation action would be stayed, and arguably, the seller whose action is stayed will share in the distribution of the estate as a general unsecured creditor, or, if the court grants the reclamation, the court will be powerless to substitute an administrative claim or security for the seller's goods. This type of analysis, however, appears wholly inconsistent with a key purpose of section 546(c)—to remove the confusion theretofore surrounding reclamation.

The seller will be limited further in reorganization cases by reason of section 546(c)'s requirement that the debtor receive the goods "while insolvent." The Bankruptcy Code defines "insolvent" as when the debtor's liabilities exceed its assets at a fair valuation.⁴⁵ The definition of insolvency in the U.C.C. includes the bankruptcy definition as well as the equity definition; *i.e.*, a person is insolvent "who either has ceased to pay his debts in the ordinary course of business or cannot pay his debts as they become due or is insolvent within the meaning of the federal bankruptcy law."⁴⁶ In many reorganization cases the debtor will be solvent in the strict bankruptcy sense, but insolvent in the equity sense. In such situations, the seller will be denied reclamation if the courts adhere to the definition of insolvency in the Code.

With respect to the issue of insolvency, section 547 of the Code dealing with preferences presumes that the debtor is insolvent during the ninety days immediately preceding the date of the filing of the petition. This presumption is also the case with respect to setoff under section 553 of the Code. The House Judiciary Committee Report, commenting on the proposed bankruptcy reform legislation, made some interesting observations concerning the subject of proof of insolvency:

44. See Orr & Klee, *supra* note 40, at 343.

45. 11 U.S.C.A. § 101(26) (1978).

46. U.C.C. § 1-201(23) (1972 version).

The preference section requires the bankruptcy trustee to prove the debtor's insolvency at the time the preferential transfer was made. Given the state of most debtor's books and records, such a task is nearly impossible. Given the financial condition of nearly all debtors in the three months before bankruptcy, the task is also generally not worth the effort. Rarely is a debtor solvent during the three months before bankruptcy. Thus, the preference section requires the trustee to prove a fact that nearly always exists yet never can be proved with certainty.⁴⁷

Also, section 303 of the Code provides that an involuntary case may proceed if the debtor generally is not paying its debts as they become due. Section 546(c) itself refers to state statutes, namely, the U.C.C., yet uses "insolvency," one must assume, as defined by the Bankruptcy Code. The Code, however, is replete with references to insolvency in the equity sense.

It is unfortunate that these ambiguities were not removed in the drafting of section 546(c). When the Code was in the process of being drafted, the National Bankruptcy Conference proposed a section to the House bill to deal with reclamation, a subject not addressed in the early drafting. That section was intended to make section 2-702 of the U.C.C. inapplicable in bankruptcy cases and substituted a rule of fraud derived from the common law.⁴⁸ The Senate subcommittee considering companion legislation incorporated a new version of section 2-702(2) into the proposed bankruptcy act.⁴⁹ The Senate's proposal would have removed the obstacle of proving insolvency. It failed, however, to deal with the rights of bona fide purchasers and superior liens. Section 546(c) is the outcome of these two proposals and is essentially a resort to state law with certain limitations imposed. As

47. H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 178-79 (1977).

48. See Weintraub & Edelman, *supra* note 4, at 1165-66.

49. This proposal read as follows:

Sec. 4-407. Right of Reclaiming Seller—A seller's right under state law to recover property sold upon subsequent discovery that buyer received the property while insolvent or at a time when buyer had ceased to pay his debts in the ordinary course of business or had an inability to pay his debts as they became due shall not be defeated upon the commencement of a case under this Act by or against the buyer as debtor because of anything contained in section 4-405 or 4-406 provided:

(1) debtor received the property on credit or payment by draft which was subsequently dishonored; and

(2) within ten days of debtor's written receipt of property seller made a written demand of debtor that property be returned; and

(3) at the time of debtor's receipt of the property seller had no actual knowledge of the contemplation of the filing of a petition under this Act by or against the debtor.

such, it should permit reclamation to continue to be a fruitful ground for litigation and controversy.

UNRESOLVED ISSUES

It is salutary that many of the problems inherent in section 2-702 reclamations were addressed by the Code. Unfortunately, many questions, which may involve protracted and expensive litigation and impair the efficient administration of bankrupts' estates, remain. This fact is inconsistent with one of the fundamental aims of the reform legislation—to create an efficient and fair mechanism to deal with bankrupts' estates. Some of the more salient unresolved issues are discussed below.

Reclaiming sellers may be faced with problems of identifying the goods in the hands of the debtor. The U.C.C. right of reclamation is essentially a right to obtain the physical return of particular goods in the hands of the debtor or trustee and identifiable as such.⁵⁰ Accordingly, reclamation may be denied when the goods were used and, because of their use, are no longer identifiable or are unidentifiable because of their inherent nature, such as in the case of fungible goods like scrap metal, stone, cement, or cattle. The burden of proof is on the reclaiming seller to establish his title and the identity of the goods.⁵¹ This burden can be extremely difficult, especially in view of the automatic stay provisions of section 362 of the Code, which prohibit the seller from proceeding on an expedited basis to secure the goods by action outside of the bankruptcy court. Moreover, the debtor or trustee may raise the issue of insolvency; in this event the burden will be shifted to the seller to prove insolvency—a difficult and expensive task, especially in any sizeable reorganization case. The existence of a blanket lien on all inventory can work to defeat the reclaiming seller, notwithstanding that the security holder may be fully secured and protected. A lender holding a security interest in the debtor's after-acquired property is considered to be a good faith purchaser, and the existence of such an interest may defeat the seller's reclamation with respect to the encumbered property. It has been asserted that such a secured creditor cuts off the rights of a reclaiming seller.⁵² Arguably, if at the time of the seller's demand the goods are subject to a security interest, the right of reclamation is never "triggered" and may not be asserted subsequently.⁵³

50. Rights in property sought to be reclaimed should be determined as of the date of the demand for reclamation. See *In re Daylin, Inc.*, 596 F.2d 853 (9th Cir. 1979).

51. But see R. DUSENBERG & L. KING, *supra* note 5, at § 13.03[4][c],[v].

52. *In re Bowman*, 25 U.C.C. Rep. 738 (N.D. Ga. 1978).

53. *In re Samuels & Co., Inc.*, 526 F.2d 1238 (5th Cir.), *cert. denied*, 429 U.S. 834

If the reclamation is valid but avoided by the trustee and a lien is granted in lieu of a return of the goods, one may question whether or not the seller becomes a secured creditor under section 506 of the Code, entitled to interest on his claim. If an administrative claim is granted in lieu of a return of the goods, then it will be argued that the claim should not receive interest and should be paid at the conclusion of the case with other unsecured claims.⁵⁴ To the extent that a profit margin is built into the sales price of the goods, interest may not be appropriate. However, goods, materials, and supplies necessary for the preservation of the estate will be ordered and paid for by the debtor or trustee in the ordinary course of business. This fact seems inconsistent with requiring the reclaiming seller to wait for payment of his administrative claim.

Additionally, it is unknown what superior state-granted interests may be uncovered to defeat the reclaiming seller. This possibility brings into focus the extent to which the bankruptcy courts must adhere to state law under the *Erie* doctrine or whether the courts can view section 546(c) as a federal right and be free to interpret the provision to conform to the dictates of federal bankruptcy law and practice.⁵⁵ If the courts must rely on local interpretation of section 2-702 of the U.C.C., unresolved questions such as the timeliness of the reclamation demand, the sufficiency of and proof of the demand, the identification of the goods, tracing of the proceeds of the goods, the date of buyer's receipt of the goods, and the right to stop in-transit as being inconsistent with reclamation, will continue to bring about confusion and inconsistent results.⁵⁶

Examination of these unresolved issues focuses attention on fundamental policy considerations and the balancing of conflicting rights of the seller versus the trustee, other secured parties, and purchasers for value. The early defenders of the Bankruptcy Code against reclaiming sellers obviously were fearful that to grant reclamation would open the doors to state-created priorities and defeat one of the essential purposes of the federal bankruptcy legislation, the determination of priorities. This worry should no longer be of major concern to those interpreting the new Code, as

(1976). See *Sorrels v. Texas Bank & Trust Co. of Jacksonville*, 597 F.2d 997 (5th Cir. 1979).

54. If the trustee loses in contesting a reclamation petition, the cost of the proceeding will be imposed on the estate as an expense of administration, in which event interim legal fees, being expenses of administration, generally are awarded and paid to the counsel engaged by the trustee. The trustee's fees similarly are paid.

55. *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938). See Hill, *The Erie Doctrine in Bankruptcy*, 66 HARV. L. REV. 1013 (1953).

56. See Weintraub & Edelman, *supra* note 4, at 1171.

many of the open issues concerning statutory liens have been clarified by the reform legislation. Rather, the right of reclamation should be viewed in light of the possible benefits of granting this right toward some better measure of consistency and uniformity.

PROPOSALS

The day-to-day realities of business transactions are that a debtor faced with serious financial circumstances is concentrating maximum effort on maintaining operations to generate sales and cash, while seeking additional financing or extensions of existing financing. As such, he must have raw materials and other supplies delivered on credit, notwithstanding that he knows he cannot pay for them. Creditors, generally unaware of these circumstances, continue to supply these essential materials, with the expectation of payment. It seems appropriate to recognize that these situations frequently occur and to reevaluate traditional notions of fraud. The consideration that the debtor may need to continue dealing with his suppliers subsequent to the filing of a bankruptcy petition should be an important factor in determining how to treat reclamation. The moral principles involved tend to become confused with so many divergent interests at stake. Creditors who feel defrauded are unlikely to deal at arms length after a petition has been filed. Buyers may be caught up by ethical issues involving conflicting duties to suppliers and to the buyer entity, its employees, and shareholders. The preparation and filing of a bankruptcy petition is usually a measured action, often requiring lengthy analysis and formal action by a board of directors.

To the extent that merchandise is obtained under these circumstances, creditors may urge that merchandise was obtained by fraudulent means and, therefore, that the underlying indebtedness may not be discharged in bankruptcy.⁵⁷ In the final analysis, the debtor's business may suffer rather than gain from the protection of the bankruptcy proceedings if wronged sellers are not treated expeditiously and fairly. It is submitted that lenders and other secured creditors are in a better position to protect their interests and usually do not count on goods that are the subject of reclamation in their basic security packages. Bona fide and good faith purchasers of

57. The Bankruptcy Code denies a discharge as to all debts if the debtor has engaged in certain prohibited conduct. 11 U.S.C.A. § 727(a) (1978). Corporations and partnerships are eligible for discharge in Chapter 11 reorganization cases under section 1141(d), which provides that the confirmation of a plan operates as a discharge. The applicable provision of section 727 prohibits a discharge when "the debtor knowingly and fraudulently, in or in connection with the case . . . received . . . property . . ." 11 U.S.C.A. § 727 (a)(4)(C) (1978).

the goods from the bankrupt present a different set of issues; there are strong arguments to favor them over the reclaiming seller. Sellers may seek protection under the U.C.C. by taking a purchase money security interest in the goods. This safeguard, however, appears to be somewhat unrealistic to expect in the context of everyday transactions.

In the interests of balancing the equities and avoiding costly litigation, which unnecessarily saps the energies and resources of all concerned parties, a better result would be to grant administrative claims to creditors seeking reclamation under section 546(c) of the Code without regard to the need to prove "insolvency" under the strict bankruptcy definition of the Code. In this connection, it is suggested that the courts move to create a presumption of insolvency during some period, say thirty to ninety days prior to the institution of bankruptcy, and thereby shift the burden to the debtor to establish solvency, assuming that the debtor wishes to contest the reclamation. Likewise, the Uniform Commercial Code requirements to identify the goods or trace the proceeds should be disregarded, unless meaningful prejudice can be shown to other parties having superior interests in the reclaimed goods, such as good faith purchasers or secured parties who are not otherwise adequately protected in the case. If a reclamation demand is properly made, yet the goods are subsequently used or sold, the seller should be entitled to be paid promptly pursuant to an administrative expense claim. Moreover, the presence of a fully-secured lender holding a blanket lien or security interest in all of the debtor's property should not work to defeat the reclaiming seller. Although the language of section 546(c) seems to dictate a resort to state law, particularly the Uniform Commercial Code, local requirements, such as the timeliness of the demand and the sufficiency and proof of the demand, should be construed in the context of the Code so as to grant more uniformly reclamation when the seller is not otherwise precluded by the trustee's avoiding powers or other provisions of the Code. The *Erie* doctrine notwithstanding, to do otherwise will tend to resurrect the pre-Code confusion surrounding reclamation. The unresolved issues surrounding U.C.C. section 2-702 and previously mentioned should not be litigated in the bankruptcy courts.

The magnitude of reclamation proceedings in major bankruptcy cases frequently has given rise to the creation of special priority classes of creditors who shipped or delivered goods within a defined period before or after the filing of the petition. In the Chapter 11 reorganization proceedings involving *City Store Company, B. Lowenstein & Bros., Incorporated* and *W. & T. Sloan, Inc.*, the general creditors, who in good faith delivered goods which were

received by the debtor within a fourteen-day period preceding the bankruptcy, were to receive according to the Debtors' Consolidated Plan of Arrangement an additional 10% of their claims, to be paid in cash upon the consummation of the plan.⁵⁸ Likewise, in the *J. M. Fields, Inc., Food Fair, Inc.* proceedings, the plan provided for special treatment of claims resulting from sales and deliveries of merchandise received during a five-day period preceding the bankruptcy proceedings.⁵⁹ These special arrangements worked to dispell any notions that the merchandise was obtained under fraudulent conditions. In the case of *Hartfield-Zodys, Inc.*,⁶⁰ all reclaiming sellers properly making a demand under the U.C.C. were assured of an administrative claim and much unnecessary litigation thereby was avoided.

It has been suggested that reclamation demands be uniformly granted as administrative claims to all sellers who have delivered goods to the debtor within the ten-day period following the filing of the bankruptcy petition.⁶¹ This kind of provision and similar arrangements have been made in a number of cases and have worked well. The simplicity of this approach has a great deal of merit and avoids the difficult and complex resolution of the competing interests in the goods sought to be reclaimed and the issues involving insolvency.

Under this approach, the seller who ships goods shortly before the petition and has, for example, his goods delivered after the ten-day period has run will lose. This example suggests the need for the retention of common law remedies involving principles of fraud or the concept of insolvency embodied in the U.C.C. Most sellers, however, should be encompassed in such a ten-day period. This approach to the problem, therefore, deserves attention by bankruptcy counsel and the courts and can be made part of bankruptcy, especially reorganization proceedings. It is incumbent on the bankrupt's counsel to grasp quickly the magnitude of reclamation proceedings in the case and to implement such an approach whenever appropriate.

This approach may in time lead to a revision of the Code to embody its underlying concept, but the adoption of such an amendment does not seem too realistic in view of the other competing interests and the difficulties of resolving them in favor of the seller. Such a revi-

58. Nos. 79B 1320-79B 1323 (S.D.N.Y.).

59. Nos. 78B 1764-78B 1773 (S.D.N.Y.).

60. Nos. 74B 1633-74B 1634 (S.D.N.Y.).

61. See Weintraub & Edelman, *supra* note 4, at 1176. Messrs. Weintraub and Edelman unsuccessfully proposed this solution to the drafters of section 546(c) of the Code.

sion, however, would encourage the creation of an independent, federal reclamation right for employment in bankruptcy cases.⁶² In the meantime, bankruptcy rules cannot be a solution. Section 247 of the Code deletes the prior *caveat* that bankruptcy rules promulgated by the United States Supreme Court take precedence over conflicting provisions in the statute.

Section 546(c) of the Code provides the framework for the courts to improve the handling of bankrupt estates, especially in large reorganization cases involving retail establishments where reclamation often becomes an important factor. It is hoped that the courts will not become bogged down in technical interpretations of section 546(c) which can be argued to deny reclamation in its present framework under the Code, but will maintain sight of the underlying theme that reclamation be recognized consistently.

62. It is hoped that a federal right of reclamation would remove any questions about whether section 546(c) in its present form revives common law reclamation, which was resorted to in *JayLaw Drug, Inc.*, 2 Bankr. Ct. Dec. 867 (S.D.N.Y. 1976), in spite of the provisions of U.C.C. § 2-702(3), which supplant all common law remedies.